Testimony Concerning

"Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors"

by

William O'Brien
Chief Executive Officer
Direct Edge

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Chairman Garrett, Ranking Member Waters, Vice Chairman Schweikert and Members of the Subcommittee, I would like to thank you for the opportunity to testify today on behalf of Direct Edge, the operator of the one of the largest stock markets in the nation and the world. Over the past five years Direct Edge's market share of U.S. stock trading has risen to approximately 10 percent because we have innovated in response to changing market structure to provide new solutions for brokers and their customers. This innovation is possible only in an atmosphere of continued investor and issuer confidence in our nation's markets and how they are regulated. As discussed in our remarks, we believe this confidence to be at a low point, and that we are in need of targeted efforts to improve it. In this regard, the work of the Subcommittee in conducting this hearing is timely and valuable.

Direct Edge believes that through careful examination, appropriate steps can be taken to improve investor confidence in a fair and orderly market without restricting innovation, competition or efficiency. To this end, Direct Edge offers the attached Statement of Market Structure principles that we believe should guide any reforms, in order to focus the current dialogue on what really matters – improving our stock market for the benefit of the nation's investors.

Statement of Market Structure Principles

Direct Edge

"Restoring Confidence"

June 20, 2012

Introduction

Investor confidence in U.S. equity market structure is perhaps at its lowest point since the Great Depression. A 2010 Associated Press/CNBC poll showed that 86% of respondents believed that the stock market was “not generally fair” to small investors. Since that time, several high-profile incidents have led the investing public to seriously questions whether the stock market is on a sound operational footing. You can question the merit of such concerns – but you cannot deny they exist.

An intellectually consistent and operationally feasible plan is needed to start the process of restoring that confidence. This is essential to return the stock market to its rightful place – for investors and entrepreneurs alike – as a pivotal tool for achieving the American dream. Small investors will have great difficulty reaching their financial goals if they are driven to primarily invest in “risk free” assets due to confidence-related concerns. Small companies will find their access to equity capital markets limited without a vibrant secondary trading markets for equities, inhibiting corporate growth and the job creation that comes with it. Collectively, a healthy stock market is a critical element of building an ownership-based society where Americans are increasingly united in the common goal of furthering prosperity. A healing process needs to occur, and actions will speak louder than words. Direct Edge remains hopeful, because we believe that there are relatively simply and tangible steps that can be taken to start the work of restoring investor confidence.

In this vein, Direct Edge offers this statement of the principles, and related actions, it believes will help restore investor confidence and provide a better environment for the trading of small and large-company stocks alike. In doing so, we hope that like-minded market participants will proffer their support, in whatever means they find advisable, in order to focus the current dialogue on what really matters – restoring faith in our nation’s stock market for the benefit of all. Whether you agree in whole, in part, or not at all, we hope you find in these principles a healthy construct in which to discuss the issues and chart a path forward.

1. <u>Monopolies are not the answer – more efficient competition is</u>

Some argue that confidence is undermined by the choices that investors have or the alleged complexity of navigating them. Often this coincides with claims that efforts should be made to re-consolidate trading into a smaller number of venues, pleas to "level the playing field" by severely restricting certain business models, or giving regulators or issuers the ability to create new market monopolies. Retail order handling, "dark pools" and other trading alternatives often bear the brunt of these criticisms. This is the wrong path to pursue.

Direct Edge does not believe investors will have more confidence in the stock market by reducing the number of choices that investors and their brokers have. People don't think the soap market is unfair because there are 500 different kinds of soap. And they don't think the stock market is unfair because there are 50 places to execute their trade. The proliferation of trading alternatives has only served to lower costs, improve technology and give each investor a solution that is better tailored to their trading and investing needs.

At the same time, cooperation among competing venues does need to be improved. The May 6, 2010 "flash crash" and recent IPO troubles were <u>not</u> caused or made worse by fragmentation, but by insufficient <u>communication and coordination</u> between exchanges to deal with these situations. During the recent IPO-related issues, the relevant listing exchange had a <u>total</u> monopoly, and were "single points of failure" that in fact, failed. This was exacerbated by the lack of sufficient market-wide communication while events unfolded. At Direct Edge, we had no greater visibility into what was occurring than the average retail investor. No hotline, no market-wide escalation procedures, no nothing.

We can easily improve this, and the work has already started. The market-wide single stock circuit breakers and recent SEC approval of a "limit up/limit down" mechanism help assure that all trading venues will deal with sharp and sudden changes in stock prices in a cohesive manner. More work can be done to ensure that in key market events – especially when things go wrong – all the exchanges can quickly and effectively work together to prevent problems from cascading and protect investors.

2. **Rather than restrict off-exchange trading, exchanges should have greater freedom to make their markets more appealing to retail and institutional order flow**

Even though Direct Edge is one of the world's largest stock exchange operators, we do not believe that exchanges have some divine right to execute every trade. To start with the premise that there is an "unlevel playing field" is unfairly accusatory and alarmist, and does nothing to restore investor confidence. While it is true that exchanges and non-exchange venues have different responsibilities and privileges, the focus should be on ensuring that exchanges can consistently provide great results for a broad spectrum of investors. Direct Edge believes we are better as both a country and a company when exchanges have to earn their business, and have a robust capability to do so.

Exchanges are at times hamstrung, however, because of the current application of the principles of "fair access" under federal securities regulation. Exchange efforts to provide a better experience for retail and institutional orders are often reviewed under the principle "if it isn't made available to everyone, it can't be made available to anyone". As a result, exchanges can be constrained in their efforts to provide a better environment for retail and institutional investors. This can lead the firms who manage this order flow to seek off-exchange executions. There is nothing nefarious about this, in fact it is consistent with the duty of best execution. If exchanges don't offer the best trading experience, trading volume should and will go elsewhere.

Section 6 of the Securities Exchange Act of 1934 should be modified to clarify that exchanges have the freedom to provide tailored solutions for institutional and retail orders. Stock exchanges function best when diverse participants all believe they are getting a near-optimal outcome. This gives them the confidence to submit their order into a trading venue with maximum transparency, price discovery and liquidity. Rather than criticize the increase in off-exchange trading, empower exchanges to offer a better product and experience to long-term investors. Not only would this help restore investor confidence, it would prospectively improve trading outcomes.

3. Enhance SEC Oversight of Exchange Technology

Exchanges play a special role in our capital markets with respect to both investor confidence and capital formation. In the minds of most American investors, it is assumed that exchange operations are rock-solid. That assumption has been seriously undermined by recent events. No exchange, Direct Edge included, has been immune to this.

The rise of for-profit exchanges, the dynamic nature of our business, and some exchanges' continued push into related technology businesses has created the potential for conflict between exchanges' risk-management practices and their profit motive. While this tension between short-term rewards and longer-term risks exists in almost all businesses, the role of exchanges in preserving investor confidence makes proper balancing of these needs particularly acute. Regulators have been vigorous in their efforts to oversee exchange technology practices, but their mandate should be strengthened further in this area.

The priority and primacy of these efforts can be augmented by formally proposing and adopting the SEC's Automation Review Policy ("ARP") as official regulation under the federal securities laws. The risk-management practices currently reviewed as part of ARP inspections are comprehensive, covering several areas that have been recent sources of investor concern: information security, quality assurance testing, and incident management to name just a few. Direct Edge has made considerable investments of time, talent and technology in response to feedback provided by ARP examiners. The ARP program, however, is still technically voluntary for most trading venues. This allows exchanges and other impacted market participants considerable leeway in negotiating with regulators about what risks should be addressed and when.

Proposing and adopting ARP as an official rule of the Commission would provide even greater authority to ensure that complex trading technology and infrastructure is managed prudently and with the ongoing stability of our stock market as a principal objective. It would send a powerful message to investors that regulators recognize the impact of the series of "glitches" our markets have suffered, and are working to further mitigate these risks.

4. **Incentivize and ensure the responsible use of technology rather than seeking to turn back the clock**

The debate over the fairness of the stock market has been unique in its criticism of the technological advancement that has swept every aspect of American life. By almost any measure, the transition from manual to electronic trading has lowered costs, improved execution quality and access to liquidity for retail investors. Automation has also significantly improved market consistency, made the "paper trail" easier for regulators to follow, and allowed for the quick and effective implementation of solutions like the post-"Flash Crash" single-stock circuit breakers. Thus the increasing automation of the stock market should be viewed as something that works to greatly improve investor confidence. But yet it remains a significant source of angst.

Efforts to make trading slower generally, or restrict the technological capabilities of certain players are both unfeasible and undesirable. They would not make our markets safer, sounder or stronger. And there would be no rational argument that investors should feel more confident in investing in equities as a result. More likely outcomes are that: (i) significant implementation issues would prevent these measures from working as planned; and (ii) technologically-advanced trading would migrate off-shore. Either would work to further undermine investor confidence in both the short and long term.

Efforts can be made to encourage and monitor how trading technologies are used so the benefits automation brings are not overshadowed by aberrant or inefficient behavior. Direct Edge was the first U.S. stock exchange to announce and implement a program intended to impose economic penalties on trading firms that had excessively high message-to-trade ratios. Our Message Efficiency Incentive Program prompts trading firms to examine their behavior and suffer the consequences if they choose to flood our market with orders that seldom or rarely result in trades. This gives our members the freedom to use technology as they see fit but at the same time the responsibility to use this technology efficiently. This notion of shared responsibility should be the foundation of any effort to ensure that market technology is used prudently.

5. **Investors should have transparency regarding where their orders are routed, in addition to where they are executed**

It is difficult to have confidence in a process when you have limited visibility. When it comes to the trading of stocks, there are countless ways for an order to be managed in light of the facets of execution quality – such as immediacy, explicit fees and market impact – and the preferences of the relevant investor. Most investors want to delegate the responsibility to manage these aspects of execution to their chosen broker, while still having the order-handling information necessary to hold them accountable. When you don't know what is going on behind the scenes, it is hard to have absolute faith that your interests are being fully served. Trust, but verify.

One of the consequences of greater investor choice and increasing market technology is that it can be hard for an investor to answer the basic question – "what happened to my order?" Investors can be left wondering if they have complete information and brokers are more susceptible to allegations – substantiated or not – of order mishandling. Where information can be efficiently used to allay these concerns, it can help restore confidence not only in an investor's ability to choose a broker, but in the market itself.

There are multiple ways to efficiently achieve this objective both on a holistic and an order-by-order basis. The order-routing disclosures of SEC Rule 606 could be expanded to list not just exchanges and other market centers where investor orders are executed, but where they are routed (whether executed or not) as well. For institutional and other savvy investors, standardized market identification codes can be implemented to provide this information on an order-by-order basis. Measures like this will "pull back the curtain" from the order-management process, and rather than revealing general malfeasance, show what is true – thousands of professionals hard at work to give investors great execution outcomes every day. And any sub-optimal order-handling practices will be much easier for investors and regulators to spot and hold the relevant parties accountable.

6. Regulation should be made more flexible to enhance the trading experience for smaller companies

Just as all investors are not created equal, each listed company has a variety of unique attributes and needs. From the international consumer conglomerate to the start-up bio-tech company to the white-hot social media juggernaut, the reasons for utilizing the equity capital markets vary greatly, as do their needs regarding secondary-market trading.

An unintended consequence of Regulation NMS is the tendency to impose a “one size fits all” version of market structure on issuers, regardless of their characteristics and needs. The small cap stock with a trading volume of 10,000 shares per day is traded within the same market structure as Bank of America, with a daily volume of 25,000 times that amount. While the reasons companies decide if and when to go public extend far beyond market structure concerns, the trading environment presents challenges for smaller companies. As a result of all these factors, potential public companies may remain private for longer periods. This in essence lures investors interested in these companies into trading on private markets which require less financial disclosure, have increased trading cost and reduced transparency. Work needs to be done to get the next generation of great American companies listed and trading on the public markets.

The legislative proposal put forth by Representative McHenry would be an important first step in making exchange markets a more hospitable place for small public companies. The proposal, which would allow exchanges to create and administer incentives to ensure the provision of liquidity for their stocks, would give companies more meaningful choices. The ability to realize the benefits of the public markets without concern that you would be “orphaning” your new investors in a market with little liquidity would increase the confidence of both CEOs and fund managers alike to encourage the pursuit of the IPO alternative. There are many ways to raise capital, but an exchange IPO is a uniquely important event in the growth cycle of a good company. All reasonable ideas in furtherance of making this alternative as accessible as possible should be considered and pursued with vigor.

7. A national "Depth of Book" data feed should be created to allay concerns about informational advantages

Renewed efforts should be made to broaden the availability and lower the price of depth-of-book market data to investors. Changes in market structure since decimalization have dramatically increased the need for this information. Investors and intermediaries often use exchange depth information to better understand the market-wide liquidity in the stocks they trade.

The process for acquiring and using this data is currently cumbersome and expensive, and can lead to the "rationing" of this important information. Market participants must compile this data from multiple exchanges across several data centers. This entails significant fixed costs even before any explicit exchange market data fees are paid, with total costs for retail firms of upwards of $1 million or more per month. This leads to such information being restricted to investors, creating the perception of "haves" and "have nots". Rightly or wrongly, the mere existence of such a perception dictates the need to provide more efficient ways of getting depth quote and trade data to more investors.

A potential solution, recently discussed in a research paper authored by the research firm the TABB Group, is to create a nation-wide depth-of-book data feed through the existing infrastructure that exists for top-of-book data. Doing so would eliminate significant costs and produce material market efficiencies. Market participants are already connected to this infrastructure for the receipt of market data, and can leverage existing connectivity and infrastructure to receive depth data should they so choose. Some investment in the existing network may be required, and governance safeguards may be necessary to ensure appropriate service levels and fees. These measures, however, can be effected at a cost that is insignificant when measured against the potential savings to the entire industry and the improved perception of equal information. Retail investors would no longer have, as one commentator once put it, "little choice… to obtain multiple proprietary exchange feeds – or [have] a view of the market that is increasingly incomplete." It would be good for business and good for confidence at the same time.

8. **<u>The Consolidated Audit Trail should be approved, built and funded</u>**

People have confidence when they believe the “cops on the beat” have the tools they need to do their job, and the stock market is no different. While had to prove, it is easy to state that the technology and diversification of modern markets make it impossible for regulators to deter, detect and punish inappropriate conduct. For the average investor, it is all too easy to think “if the experts don’t understand what’s going on, how can I?” Clearly demonstrating that regulators have appropriate information is thus essential to making sure that investors remain confident in how are markets our working.

Direct Edge urges prompt SEC approval of the proposal to create a consolidated audit trail (“CAT”) as a means not only to detect inappropriate activity, but to serve as the “gold standard” for regulators, academics, exchanges and others to truly understand how our markets are operating. Once approved, the process for creating the CAT should be one of maximum transparency, inclusive input and access and the funding to match the importance of its role in improving investor confidence. Building the CAT the right way will take some time, but if market participants feel they have a voice and a role in the process, patience will be rewarded with a system built the right way the first time. And most importantly, no matter how many “bad guys” are truly out there, it will give investors comfort that the regulators are one step ahead of them.

9. **<u>The securities industry needs to better educate the investing public as to how modern markets operate to their benefit</u>**

At times it seems like no industry likes to scare customers away like the securities industry. Many business models appear to have as a core sales tactic the argument that every market participant is looking to take advantage of long-term investors. Like when your plumber tells you that every other plumber (except him, of course) is out to rip you off. It is hard for investors to have confidence in markets when the overwhelming volume of “analysis” tells you to run for the hills.

Exchanges and other industry-wide organizations need to make significant investment in basic investor education and communication to counter these allegations with facts and supporting information, so even competing market participants feel like partners in demonstrating that our nation's stock market is the best in the world. Direct Edge stands ready to contribute its time, talent and treasure to industry-wide, market-neutral efforts to give investors a real-world, plain-English way of understanding how stocks trade, how technology is used for their benefit, and providing answers as needed to "what happened?" when difficulties occur.

Conclusion

It is easy to talk about the lack of investor confidence in the abstract, but it has enormous financial consequences for American investors. Investors who move money from stocks to "less risky" assets risk low rates of return and less transparent fees that could severely hinder their ability to retire, pay for college, and achieve other financial goals. Some things that impact investor confidence we can't control for – such as where asset prices will head over time. But other confidence-building measures are well within our reach. The time to act is now.

This statement of principles is only part of Direct Edge's efforts to drive the market structure debate in a healthy and productive direction. We will continue to engage in partnered dialogue with our Members and evidence-based discussions with policy-makers, regulators and other thought leaders, and will offer comments and suggested policies in an appropriate and constructive manner. We look forward to a level of communication that will enhance our perspective, improve our markets and help restore investor confidence.